October 31, 1991

COORDINATED ISSUE
MEDIA/COMMUNICATIONS INDUSTRY
TRANSPONDERS

ISSUES

1. Whether a "sale" of a transponder is a sale for federal income tax purposes.

2. Assuming, that a sale of the transponder is a sale for federal income tax purposes, whether investment credit and accelerated depreciation is allowed with respect to the full amount of the purchase price or whether a portion of the purchase price is properly allocable to intangible property.

3. Assuming, that a portion of the purchase price is properly allocable to intangible property, whether that portion of the purchase price is subject to amortization.

CONCLUSIONS

1. Based on the facts outlined herein, a sale of a transponder is a sale for federal income tax purposes. However, each case should be judged on its own facts to determine whether the benefits and burdens of ownership have actually shifted to the transponder purchaser.

2. That portion of the purchase price properly allocable to an agreement allowing the purchaser to use the seller's ground stations, an extended warranty agreement, a maintenance or operating agreement or some other agreement between the seller and purchaser, and that portion of the purchase price properly allocable to a premium paid for a preferred orbital position, is not includable in the basis of the transponder for the purpose of determining investment credit and accelerated depreciation.

3. That portion of the purchase price allocable to the intangible property described above is amortizable over a period not longer that the useful life of the transponder.

FACTS

"A 'transponder' is the device on a communications satellite which amplifies and relays transmissions between 'transmit' and 'receive' earth stations." In the Matter of Domestic Fixed-Satellite Transponder Sales, 90 F.C.C. 2d 1238 n. 2 (1982).

(Hereinafter referred to as Domsat Transponder Sales, 90 F.C.C. 2d 1238.") More precisely, a transponder is a device in a satellite that accepts communication signals relayed to it from the satellite's receive antenna (which signal was received from a transmit antenna for transmission to a receive earth station), amplifies the signal, converts the signal into another frequency and relays the signal to the satellite's transmit antenna for transmission to a receive earth station.

A single satellite may have from 12 to 36 transponders. The receive and transmit antennas on the satellite handle all the signals relayed through the various transponders. Each transponder accepts only signals on the frequency for which it is programmed.

The satellite is normally powered by solar panels and once the satellite becomes operational the transponders will operate automatically. The satellite, itself, is maintained in its geosynchronous orbit by rocket motors. Besides the transponders, the satellite has communication devices and switches to control its position and operation. The transponders, however, are the heart of the communications link between transmit and receive earth stations.

Transponders are typically used to transmit telephone, television, and radio signals and various kinds of data between the earth stations.

Prior to 1982, satellite operators (hereinafter referred to as "domsat operators") were generally required to "lease" transponders on a common carrier basis, pursuant to Title II of the Communications Act of 1934. 47 U.S.C.A. sections 201-224 (1962 & Supp. 1988). (Hereinafter referred to as the "Act") (The best known common carriers are the various telephone companies.) Under 47 U.S.C.A. sections 201 and 202 a domsat operator (the common carrier) was required to furnish communications services to customers on a first-come, first serve basis. The domsat operator was also subject to considerable regulation with respect to the prices it charged customers referred to as tariffs, including price controls.47 U.S.C.A. section 203.

The Federal Communications Commission (FCC) allowed domsat operators to enter into long term exclusive leases of transponders even though the leases were technically on a common carrier basis. The leases gave the end user/lessee the exclusive right to use the transponder over the transponders useful life.

The rents charged end users were often equivalent in amount to the purchase price of transponders under the sales at issue here.

In 1982, the FCC ruled that certain satellite owners could sell transponders on specific satellites to end users. Domsat Transponder Sales, 90 F.C.C.2d 1238. In so holding, the FCC expressly removed the transponders that were to be sold from the jurisdiction

of Title II of the Act.

The United States Court of Appeals for the District of Columbia affirmed the FCC's holding in World Communications, Inc. v. Federal Communications Commission, 735 F. 2d 1465 (D.C. Cir. 1984). The court, in describing the sale of transponders stated:

> A transponder sale contract conveys to the purchaser an exclusive ownership right in a specific transponder during its useful life. The purchaser may use the property thus acquired as collateral for loans, and may enjoy certain tax benefits as a result of transponder ownership- notably, accelerated depreciation deductions and investment tax credit. The satellite owner, however, retains responsibility for the operation of the satellite. Sale transactions are not subject to the first-come, first-served allocation mechanism of common carrier service. Buyers negotiate the right to use specific transponders directly with the satellite operator, sometimes even before the satellite is launched. The price is set by contract and is not subject to government regulation.

Id. at 1471. The Court also described the FCC's reasoning for allowing the sale of transponders:

> In explaining its decision, the Commission first discussed the potential benefits of the proposed transaction. Transponder sales, it found, would provide a means for would-be satellite operators to raise the capital needed to enter the market; further, sales would provide a mechanism for gauging demand, and would facilitate risk sharing. Sellers would have an incentive to innovate by designing systems to fit particular users' needs. Buyers could plan ahead with the assurance that desired satellite capacity will be available to them at a set price when they need it. Sales transactions could be structured to meet the specific needs of particular satellite operators and end users; and satellite operators through their selection of purchasers, could take advantage of complementarities among users.

Id. at 1472.

Although the FCC removed certain transponders from Title II regulation, the domsat operator is still subject to Title III of the Act. 47 U.S.C.A. sections 301-399b. Title III of the Act generally requires that the operator of a transmitter of radio signals have a license from the FCC granting him the authority to use a particular frequency for transmissions. The FCC considers a communications satellite a transmitter of radio signals and, thus, the domsat operator must have a FCC license to operate the satellite. Domsat Transponder Sales, 90 F.C.C.2d 1238.

The license granted the domsat operator contains authorization to position the satellite

in a particular orbit above the Earth and authorization to use various frequencies for transmission of communication signals to Earth. The various frequencies for transmissions of communication signals to Earth are emitted by the transponders on the satellite, one frequency per transponder.

Under Title III of the Act, a license granted by the FCC cannot be for a period in excess of 10 years. 47 U.S.C.A. section 307(c). All the licenses granted to domsat operators by the FCC have been a period of 10 years with temporary renewals if the satellite stays operational for a longer period. However, most satellites stay operational approximately for 10 years. Some of the newer satellites last longer. Many of the transponder sales contracts estimate a useful life for the purchased transponders of approximately 10 years, although the purchaser retains title to the transponder for its entire useful life.

The operator of a transmit earth station which transmits communication signals to the satellite must also obtain a license from the FCC because a transmit earth station is also considered a transmitter of radio signals under Title III of the Act. Domsat transponder Sales, 90 F.C.C.2.d 1238. Pursuant to FCC regulation, the frequencies allocated to transmit earth stations are in a different range than the frequencies allocated to transponders. 47 C.F.R. section 25.202. Thus, the frequency on which a signal is emitted by a transmit earth station to a particular transponder will always be different than the frequency emitted by that transponder to a receive earth station.

The purchaser of a transponder is not required to have a license to use the transponder. The FCC held, in Domsat transponder Sales, 40 F.C.C.2d 1238, that the sale of a transponder does not constitute a transfer of control of a radio transmitter, which requires the transfer of the FCC license and FCC approval pursuant to 47 U.S.C.A. section 310(d). In explaining why it did not think a transponder purchaser is required to have a license, the FCC stated:

> We do not believe there is anything intrinsic to transponder sales that now requires us to individually license the transponders. The buyer of a transponder, like a lessee under tariff, [i.e., the lease of a transponder from a common carrier,] is unable to exercise licensee responsibilities because of the limited nature of its ownership rights. Each of the sellers has represented to the Commission [FCC] requirements regarding operation of the satellite in orbit. The buyer only obtains ownership rights to the transponder equipment. Any rights to use the associated frequency are the same whether provided by the sales contract or pursuant to a tariffed lease arrangement. Therefore, it has no means to control the facilities power or transmissions. Thus, we believe that theses transactions do not involve the transfer of control of a Title III license.

Id. An operator of a receive earth station is also not required to have a FCC license.

A FCC license does not give the licensee any ownership rights, or a vested interest in, the orbit assigned the satellite or the frequencies assigned to the transponders. The licensee cannot convey the license without FCC's permission and the license cannot be security for a debt. In short, the licensee merely has permission to use a particular radio frequency or position in space. See 47 U.S.C.A. sections 301, 304, 310(d); Ashbacker Radio Corporation v. FCC, 326 U.S. 327 (1945); In re Application of Merkley, 54 R.R.2d 68 (1983).

Furthermore, the domsat operator has no guarantee that after the satellite's useful life, the FCC will renew the domsat operator's license to put another satellite, with new transponders in the same position as the old satellite and to operate the new transponders on the same frequencies. However, the FCC has granted such renewals as a matter of course, excepting unusual circumstances.

A typical transponder sales contract transfers title to one or more transponders from the domsat operator to the purchaser for an indefinite period of time. The sales contract usually contains an estimate of approximately ten years for the useful life of the satellite and transponders. The agreement usually states the title to the transponders. is conveyed free form all liens, charges, claims or encumbrances and without limitations. In effect, the purchaser has the exclusive right to the transponders.

The sales contract typically states that title to the transponders only passes when the satellite is in its designated orbit and the satellite and transponders have been fully tested and are fully operational. The purchase price is usually paid in full before title passes, i.e., before launch of the satellite, but the sales contract usually provides for refund of the purchase price if title cannot be passed to the purchaser.

The sales contract usually contains warranties that if any of the purchased transponders fail to function properly after transfer of title and during their useful lives, the seller will transfer title to a spare transponder on the same or on a different satellite to the purchaser for no extra charge.

The sales contract may also contain a provision refunding a portion of the purchase price upon failure of the purchased and spare transponders during their useful lives if the failure is due to circumstances within the control of the domsat operator. The refund is usually calculated by multiplying the purchase price by a fraction representing the time remaining in the useful lives of the transponders. Some sales contracts also allow for a refund of a de minimis amount upon the failure of the purchased and spare transponders.

If the transponder purchaser does not have its own transmit and receive earth stations, the sales contract may also include provisions for the purchaser to use the seller's earth stations. The sales contract may or may not contain an express allocation of a

portion of the purchase price to the agreement for the use of the seller's earth stations.

The sales contract usually contains an agreement in which the domsat operator agrees to maintain the satellite and keep it in its designated orbit. This function is typically called "Tracking, Telemetry and Control" or "T,T&C".

The sales contract may also give the purchaser a right of first refusal to enter into a similar contract with the seller with respect to a new satellite at the end of the original satellite's useful life. The sales contract usually states that the purchase price of a transponder on the new satellite will be negotiated in the future.

It can be argued that the sales contract contains an implied agreement between the domsat operator and the transponder purchaser giving the transponder purchaser the right to use the frequencies allocated to the purchased transponders. The domsat operator obtained the license from the FCC, has control over the frequencies and is responsible for their use. Thus, even though the sales contract does not expressly mention such an agreement the agreement must implicitly exist because otherwise the purchaser could not use the frequencies allocated to the transponders.

It may also be argued that a portion of the purchase price is a premium paid for a preferred orbital position. There are a limited number of spots where a satellite can be positioned so that signals emitted from the transponders can reach all 50 states. In fact, all these positions have been filled up at this time. A purchaser would pay a premium for a transponder on a satellite in such a position and this premium should be allocated to an intangible asset called the preferred orbital position rather than to be the actual transponder.

SERVICE POSITION AND RATIONALE

Issue 1:

In computing net income, a taxpayer is permitted to deduct a reasonable allowance for the exhaustion, wear and tear of property held for the production of income. I.R.C. section 167.[1] While it is generally the owner of record who bears the burden of exhaustion of the property, courts have refused to permit the transfer of formal legal title to shift the incident of taxation attributable to ownership where the transferor continues to retain significant control over the property. Frank Lyon Company v. United States, 435 U.S. 561, 572 (1978). Rather, the availability of a depreciation deduction is predicated upon a capital investment in the property as opposed to the transfer of

[1]All section references are to the Internal Revenue Code of 1954: i.e., the Code as it existed before the Tax Reform Act of 1986.

mere legal title in the property. Tolwinsky v. Commissioner, 86 T.C. 1009 (1986); Gladding Dry Goods Company v. Commissioner, 2 B.T.A. 336 (1925). In other words, the economic substance of a transaction, rather that its form, governs for tax purposes. Gregory v. Helvering, 293 U.S. 465 (1935).

The term "sale" is given its ordinary meaning for federal income tax purposes and generally is defined as a transfer of property for money or a promise to pay money. Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221 (1981); Commissioner v. Brown, 380 U.S. 563, 570-571 (1965). Whether a transponder sale is a sale for federal income tax purposes is determined by whether or not the benefits and burdens of ownership passed to the transponder purchaser. This is a question of fact which must be ascertained by the written agreements read in light of the attending facts and circumstances. Towlinsky v. Commissioner, 86 T.C. 1009 (1986); Haggard v. Commissioner, 24 T.C. 1124, 1129 (1953), aff'd 241 F.2d 288 (9th Cir. 1956). The intent of the parties and the actual effect of their instrument, rather than their designation, control as to the nature of the transaction. Transamerica Corp. v. United States, 7 Cl. Ct. 441, 447 (1985).

In Grodt & McKay Realty, Inc. the taxpayers entered into a transaction in which they purported to purchase cattle. The seller, although obligated to register the cattle in the taxpayers' names, retained title in its own name. It also retained possession and control of the cattle. In holding that the purported sale was not bona fide, the Tax Court considered the following factors:

> (1) Whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity was acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property.

In Frank Lyon Company, the Supreme Court upheld the substance of the challenged multi-party sale-leaseback noting that where:

> there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

In the instant case, most of the factors listed by the Court in Grodt & McKay Realty,

Inc. have been met. Especially significant is the fact that the transponder purchaser can sell its transponder and receive all of the proceeds from the sale. Transponders are extremely valuable assets and prior to the FCC's ruling in Domsat Transponder Sales, 90 F.C.C.2d 1238 (1982), a transponder lessee could not sell a transponder, although the lessee could sell his lease. See World Communications, Inc., 735 F.2d at 1470 n. 8.

The two factors that present an issue are whether the purchaser has the right of possession and whether the purchaser bears the risk of loss or damage to the property. The right of possession factor, however, is not limited to the question of physical control. As discussed in Grodt & McKay Realty, Inc., at 1241, it includes control of the sale of the property, setting the price of sale and maintenance of the property. Under the contracts, the purchaser controls the sale and sales price of the purchased transponder. Presumably, it can direct that the maintenance agreed to by the seller can be discontinued. Thus, it would appear that the possession factor is satisfied even absent the purchaser's inability to take physical control. Furthermore, the purchaser's right to the exclusive use of the transponder could be viewed as equivalent to physical control.

Despite the extensive warranties described above, the transponder purchaser still bears a substantial risk of loss or damage to the property.[2] If the purchased and spare transponders fail as the result of an occurrence outside the control of the domsat operator, typically the domsat operator is not required to refund a portion of the consideration paid by the purchaser for the transponder. In other agreements that allow a refund even if the failure is caused by events outside the control of the domsat operator, the refund is not enough to offset the purchaser's investment. Thus, although the extensive warranties may raise a valuation issue, i.e.., whether a portion of the purchase price should be allocated to the warranty and not to the physical asset, the risk factor has been met.

Furthermore, the test in Frank Lyon Company, has also been met in this case. The transactions at issue were only possible because the FCC, after an extensive study, approved the sale of transponders. As noted by the FCC in Domsat Transponder Sales, 90 F.C.C. 2d 1238, and the Court in World Communications, the primary purpose for allowing the sale of transponders was to encourage investment, facilitate risk sharing, and as a consequence, increase the number of transponders available. (See "Facts," at 3.) Thus, the sales were not shaped solely by an intent to avoid taxation.

---

[2]It should be noted, however, that the facts of each case should be examined to determine whether warranties or determinable purchase price options are so extensive as to preclude the passing of the benefits and burdens of ownership to the transponder purchaser. See Levy v. Commissioner, 91 T.C. 838 (1988).

In conclusion, based on the facts described above, the sale of transponders is a sale for federal income tax purposes. However, the facts of each case should be examined to determine whether the benefits and burdens of ownership have actually shifted to the transponder purchaser.

Issue 2:

As stated previously, in a typical transponder sales contract, the transponder purchaser enters into a variety of agreements with the domsat operator. With the exception of the right to use the domsat operator's ground stations, [3] a transponder sales contract usually conveys the purchaser's rights in these agreements, along with title to the transponder, for one lump sum amount without any special allocations. The transponder purchaser may also pay a premium for a preferred orbital location. Thus, the issue arises as to whether any portion of the purchase price is properly allocable to the rights received by the transponder purchaser, other than the rights to the title in the transponder. If such an allocation is proper, the transponder purchaser would only be allowed investment credit and accelerated depreciation on the amount allocable to the transponder because the other rights are intangible assets for which the investment credit and accelerated depreciation are not available. See sections 48(a)(1) and 168(c)(1).

The investment credit is determined by taking the "regular percentage" (10%, as prescribed in section 46(a)(2)(B)) of the "qualified investment" in the property at issue. A "qualified investment" is defined in section 46(c)(1) as the "applicable percentage [100% in the instant case, as prescribed in section 46(c)(2)] of the basis of each new section 38 property (as defined in section 48(b) [tangible personal property for our purposes]) placed in service by the taxpayer during such taxable year." Treas. Reg. section 1.46-3(c) states: "the basis of any new section 38 property shall be determined in accordance with the general rules for determining the basis of property. Thus, the basis of property would generally be its cost (see section 1012),..., and would include all items properly included by the taxpayer in the depreciable basis of the property, such as installation and freight costs."

Similarly, for the purpose of accelerated depreciation deductions under section 168, the "unadjusted basis" of recovery property is defined as "the basis of the property determined under part II of subchapter 0 of chapter 1 [i.e., sections 1011 through 1024]...." Section 168(d). Section 167(g) also states that the basis for depreciation is the adjusted basis of the property as determined under section 1011. See also Treas. Reg. section 1.167(g)-1.

---

[3]Most of the sales agreements that contain an agreement allowing the transponder purchaser to use the domsat operator's ground stations specifically allocate a portion of the purchase price to the agreement for use of the ground stations.

Section 1011 states that the basis of property for the purpose of gain or loss shall generally be the basis as determined under section 1012. Section 1012 states that the basis of property is generally its cost.

Treas. Reg. section 1.167(a)-5 states: "In the case of acquisition on or after March 1, 1913, of a combination of depreciable and nondepreciable property for a lump sum, as for example, buildings and land, the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of the acquisition bears to the value of the entire property at that time." See also Treas. Reg. section 1.61-6(a) for determining the amount of gain on the sale of a portion of a piece of property, the basis of the larger piece must be apportioned among the smaller pieces.

Mertens Law of Fed. Income Tax. Section 23A.30 states: "where a capital expenditure is made with respect to more than one property, the expenditure is an addition to the basis of the properties which are to be allocated to the basis of each of the properties held in an amount which bear the same proportion to the payment as the value of each of the properties bears to the value of the entire property held at the date of such payment." Mertens Law of Fed. Income Tax. Section 21.32 states: "Where a mixed aggregate of assets is acquired at one time, it is necessary to allocate the total purchase price among the assets, so as to determine profit on subsequent sale of specific assets in the group of assets acquired."

Treas. Reg. section 1.167(a)-5 is most often applied to allocate a purchase price among tangible assets. For example, in S. & B. Realty Company v. Commissioner, 54 T.C. 863 (1970), the Tax Court allocated a lump sum purchase price between apartment buildings and certain furnishings that were acquired along with the buildings, for the purpose of determining the correct depreciation deductions. In Geary-Market Investment Company v. United States, 70-2 U.S.T.C. para. 9720 (N.D. Cal. 1970), the Court allocated a lump sum purchase price between the building and the underlying land that was acquired along with the building, for the purpose of determining the depreciation deductions on the building.

However, courts have also allocated a purchase price between tangible and intangible assets. In Waddell v. Commissioner, 86 T.C. 848 (1986), aff'd per curium, 841 F.2d 264 (9th Cir. 1988), the Tax Court allocated a purchase price between medical machinery and a franchise, after determining that the fair market value of the machinery was less than the value claimed by the taxpayer. The Tax Court noted that the machinery could not have a basis in excess of its fair market value. Waddell, 86 T.C. at 912. As a result of this determination, the Court reduced the amount of investment credit and accelerated depreciation originally claimed by the taxpayer on the machinery. In Lemmen v. Commissioner, 77 T.C. 1326, 1347-1350 (1981), the Tax Court allocated a purchase price between cattle and a maintenance agreement

entered into between the seller and the purchaser, after determining that the fair market value of the cattle was less than that claimed by the taxpayer. As in Waddell, the effect of this determination was to reduce the amount of investment credit and accelerated depreciation originally claimed by the taxpayer.

The law outlined above is applicable in the instant case. A transponder purchaser not only purchases a tangible asset--the transponder but also intangible assets. And, as discussed above, the basis of the transponder for investment credit and accelerated depreciation cannot exceed its fair market value at the time of the purchase. Thus, the purchase price must be apportioned between the transponder and the other intangible rights acquired by the transponder purchaser based on their fair market values. These other intangible rights include maintenance and service agreements, warranties, rights to use FCC designated frequencies, preferred orbital positions and other intangible rights that may be included in a particular sales agreement.

In conclusion, the value of the transponder(s) and the various intangibles acquired by the transponder purchaser must be determined and the purchase price allocated accordingly. That portion of the purchase price that is allocated to the intangibles is not subject to investment credit or accelerated depreciation.

Issue 3:

Treas. Reg. section 1.167(a)-3 states: "If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such intangible asset may be the subject of a depreciation allowance.* * *" See also Waddell, 86 T.C. at 912; Lemmen, 77 T.C. at 1352; Laird, 556 F.2d at 1231.

As stated previously, communications satellites and their transponders stay operational for approximately 10 years. The intangible assets purchased along with the transponder likewise have a useful life of approximately 10 years. Most sales contracts state that the extended warranty agreement and the maintenance and operation agreement expire at the end of the transponder's useful life. The right of first refusal most likely expires soon after the satellite becomes nonoperational, if not before, because that is when a new satellite is likely to be launched and new transponders offered for sale.

The agreement to use the frequencies allocated to the transponder also expires at the end of the satellite's useful life because the FCC license for the frequency use expires at the same time. An FCC license is for a period of 10 years. Until the domsat operator actually receives a new FCC license for a new satellite with new transponders, it has no rights in the new license and, thus, it would be difficult to argue that the domsat operator gives the transponder purchaser a right to use the frequencies

allocated to a new transponder under a new FCC license. Even if it could be argued that the domsat operator gives the transponder purchaser a conditional right to use the frequencies allocated to a new transponder under a new FCC license pursuant to the right of first refusal or under some other implicit agreement between the parties, the fact that their is no evidence of such and that the transponder purchaser must pay for a new transponder on a new satellite with no evidence of a diminished purchase price, weighs heavily against a finding that the right to use the frequencies has a useful life in excess of 10 years.

The same argument could be made for the premium paid for a preferred orbital position. The FCC license for the orbital position expires in 10 years and it would be difficult to argue that the transponder purchaser paid a premium for a preferred orbital position for a new satellite under a new FCC license when the domsat operator has no interest in a new license until it actually receives the new license from the FCC. Furthermore, it would be difficult to argue that the transponder purchaser pays a premium for a conditional interest in a new preferred orbital position for a new satellite considering the fact that there is no evidence of such an agreement and that the transponder purchaser must pay for a new transponder on the new satellite with no evidence of diminished purchase price.

In conclusion, the intangible assets purchased along with the transponder have ascertainable useful lives not in excess of 10 years. Therefore, under Treas. Reg. section 1.167(a)-3, these intangibles could be amortized over a period not in excess of 10 years.